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TAXATION OF PROFESSIONAL
FIRMS AS CORPORATIONS

LOUIS MAIER AND NELSON H. WILD*

THE PROBLEM

In the selection of a form of business organization, the professional man encounters rather formidable disadvantages as compared to the ordinary businessman. Legal and ethical restrictions may prevent him from choosing the most advantageous form of organization. Thus, although the size of a medical partnership or law firm may be such that the corporate advantages of centralized management and continuity of existence are desirable, as a general rule, corporations cannot engage in the practice of medicine or law.¹ Ethical considerations make the personal relationship of the professional man and his client paramount, and it is felt that the interposition of a corporation might adversely affect this professional relationship.²

In addition, while the authors believe that the different forms of business organization should be accorded the same tax treatment with the result that the election of one form over another will not depend on the tax results obtained, such is not the case. The tax tail is often so important that it wags the dog as to the selection of the proper form of organization. Tax-wise, there is a rather severe discrimina-

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¹ 41 Am. Jur. *Physicians and Surgeons*, §20 (1942); 5 Am. Jur. *Attorneys at Law*, §25 (1936). There is a small minority that permits corporations to practice medicine. *State Electro-Medical Institute v. State*, 74 Neb. 40, 103 N.W. 1078 (1905) and *State Electro-Medical Institute v. Platner*, 74 Neb. 23, 103 N.W. 1079 (1905); *State ex rel. Sager v. Lewin*, 128 Mo. App. 149, 106 S.W. 581 (1907); *Doumitt v. Diemer*, 144 Ore. 36, 23 P. 2d 918 (1933). Further, in some states it may be possible for a corporation to engage in the practice of dentistry or optometry. 41 Am. Jur. *Physicians and Surgeons*, §28 (1942). *People v. United States Medical Service*, 362 Ill. 442, 200 N.E. 157, 103 A.L.R. 1229 (1936) and annotations at 103 A.L.R. 1240. On the other hand, there appears to be no authority contrary to the rule prohibiting corporations from practicing law.

² "... the principal evils attendant upon corporate practice of medicine spring from the conflict between the professional standards and obligations of the doctors and the profit motive of the corporation employer." *People v. Pacific Health Corp.*, 12 Cal. 2d 156, 82 P. 2d 429, 431 (1938).

tion against the professional man and the sole proprietor, although the latter is free to adopt a different form of organization to avoid some of these adverse tax effects. Among the tax disadvantages of a partnership or sole proprietorship are the following:

1. The professional man is not able to include himself in a deferred retirement plan, whereby the amounts set aside each year for his benefit would be deductible and the earnings would be tax free until such time as they are taken out after retirement.³

2. Although he may deduct the premiums on group insurance for his employees, he may not deduct the premium for insurance on his own life or for health and accident insurance on himself.⁴

3. Since he is not an "employee," a self employed doctor cannot obtain social security.⁵

To meet these problems imaginative planners for a long time have tried to come up with plans which provide comparable advantages for the professional man and which are still compatible with his professional status. The purpose of this article is to examine several of the types of organizations that are available to the men of the medical and legal professions and to analyze their feasibility under the present law.

METHODS OF OBTAINING TAX EQUALITY FOR PROFESSIONAL MEN

The keystone provision defining a corporation for purposes of taxation is Section 7701(3) of the 1954 Internal Revenue Code, which states: "(3) Corporation—The term 'corporation' includes associations, joint stock companies and insurance companies." This provision under the 1954 Code is identical to that found in the 1939 Code. Thus, Regulations 118, Sec. 39.3797-2 and -3 under the 1939 Code will control until such time as the proposed regulations⁶ under the 1954 Code, published on December 23, 1959, become final. These proposed regulations state in part:

The term 'corporation' is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint stock company, and an insurance company.⁷

It would appear from the regulations that there are three forms of organization which are available to a group of professional people who would like to obtain organizational and employee benefits similar to those available to corporate employees and executives. These are the

³ Int. Rev. Code of 1954, §401(a).

⁴ Int. Rev. Code of 1954, §261. Premiums on a medical policy are deductible as a medical expense to the extent that they do not cover income disability provisions. Int. Rev. Code of 1954, §213(c)(1).

⁵ Int. Rev. Code of 1954, §1402(c)(5).

⁶ 24 Fed. Reg. 10450 (1959). [Ed. Note: Proposed Regulations Adopted Nov. 15, 1960.]

⁷ *Ibid.*

joint stock company, the common law or business trust, and the association.

THE JOINT STOCK COMPANY⁸

However, it is doubtful that the joint stock company would be acceptable, since it is the closest of the three to the pure corporation. To the writers' knowledge no attempt has been made to use a joint stock company for this purpose. Since there is no precedent, its use would involve risk of litigation. Therefore, no further consideration will be given to that form of organization in this article.

THE COMMON LAW TRUST

The common law trust, sometimes known as the business trust or the Massachusetts business trust, differs from the ordinary trust in that in the former there is a joint venture for the purpose of doing business and dividing the profits, whereas the purpose of the latter is primarily to conserve property.⁹ Nevertheless, the means of setting up both forms of trust are often similar. The common law trust undoubtedly was favored by many planners because there already had been developed a considerable body of law in respect to the form and legal incidents of such an organization. Furthermore, it apparently was felt originally that the business trust was taxable as an ordinary trust and not as a corporation, although this thought was quickly dissipated in *Morrissey v. United States* and its companion cases.¹⁰ Nevertheless, this form of organization is well adapted for the use of a professional group which wishes to take advantage of corporate taxation without being a corporation.

In Wisconsin, however, there are some distinct disadvantages to the use of a business trust. First, the Wisconsin Blue Sky Laws apply to the common law trust, so that if the total number of holders of beneficial interests exceeds fifteen, the beneficial interests must be registered.¹¹ Second, if the declaration of trust is issued to five or more persons, or if it is proposed to sell beneficial interests or certificates

⁸ Under the law of at least some states, the Association form of organization which is described later on in this Memorandum probably meets the definition of a Joint Stock Company. For a case giving a good description of a Joint Stock Company, see *Hammond et al v. Otwell et al* 170 Ga. 832, 154 S.E. 357 (1930).

⁹ *Morrissey v. Commissioner*, 296 U.S. 344, 357, 36-1 U.S. Tax Cas. ¶9020 (1935). "In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers, as in the traditional types of trusts, but to provide a medium for the conduct of a business and sharing its gains...."

¹⁰ *Ibid.*; *Swanson v. Commissioner*, 296 U.S. 362, 36-1 U.S. Tax Cas. ¶9021 (1935); *Helvering v. Combs*, 296 U.S. 365, 36-1 U.S. Tax Cas. ¶9023 (1935); *Helvering v. Coleman-Gilbert Associates*, 296 U.S. 369, 36-1 U.S. Tax Cas. ¶9022 (1935). In all these cases the taxpayer claimed that its business trust was taxable as an ordinary trust and not as a corporation. The taxpayer lost in each case when the Court held that a business trust was an association taxable as a corporation.

¹¹ Wis. Stats. §189.07(1) (b) (1957).

of membership in Wisconsin, the trust instrument must be filed with the Secretary of State and recorded.¹² There is a filing fee of \$25.00 with an additional fee of \$1.00 for each one thousand dollars of certificates sold, or offered for sale, in Wisconsin.¹³ Because the requirement of filing and recording does not apply to associations, it would seem that the association form of organization would be preferred in Wisconsin. Thus, there remains for consideration the association taxable as a corporation under Section 7701(3).

THE ASSOCIATION

The association does not have a well developed body of law upon which to depend for precedents. Nevertheless, some experience may be drawn from the many social groups that have adopted Articles of Association or a constitution and by-laws for their operation. For court precedent there have been the recent decisions in the *Kintner*¹⁴ and *Galt*¹⁵ cases, both of which involved associations. In Wisconsin there has been the relatively long experience with the Sheboygan Clinic, which has operated under Articles of Association since 1946.

The remaining portion of this article will discuss the attributes of an association taxable as a corporation in regard to the organization of medical clinics as developed by case law and as interpreted by the proposed regulations. In addition, the Appendix contains a sample form of Articles of Association for unincorporated associations as prepared by the law department of the American Medical Association. This appears to be a good basic form although it undoubtedly would have to be varied to fit the particular situation confronting the attorney.

CASES OUTLINING BASIC CHARACTERISTICS OF ASSOCIATIONS

The leading case dealing with organizations which are taxable as corporations is *Morrissey v. Commissioner*.¹⁶ The individuals involved in that situation entered into a declaration of trust and transferred certain real estate to designated trustees. The trustees sold some of this land. The remainder was improved by the development of a golf course and sold to the Western National Golf Club, Inc. in exchange for its stock. Thereafter, the trustees confined their activities primarily to the collection of moneys due and the making of distributions to the beneficiaries. Under the trust instrument the trustees had the power of sale, to make investments and generally to manage the trust estate. They could choose their own successors and add to their num-

¹² Wis. Stats. §226.14(1) (1957).

¹³ Wis. Stats. §226(3) (1957).

¹⁴ *Kintner v. United States*, 216 F. 2d 418 (9th Cir. 1954). 54-2 U.S. Tax Cas. ¶9636.

¹⁵ *Galt v. United States*, 175 F. Supp. 360 (D.C. Tex. 1959), 59-2 U.S. Tax Cas. ¶9602.

¹⁶ *Supra* note 9.

ber. Beneficial interests in the trust were evidenced by transferable certificates, but the certificate holders' votes were advisory only. The trustees were without power to bind the beneficiaries personally by any act, neglect or default and the death of a trustee or beneficiary was not to end the trust.

The trustees claimed that this organization was a trust under Section 219 of the Revenue Acts of 1924 and 1926, principally because the beneficiaries had no voice in the management or control over the trustees. Note that here the individuals involved were trying to avoid having their organization taxed as a corporation, while the Commissioner was asserting corporate liability on the grounds that this organization had the attributes of a corporation.

The United States Supreme Court held that this was a business trust and thus an association taxable as a corporation under the Federal Tax Law, since the organization had enough of the characteristics of a corporation so as to be taxed as such. Because the beneficiaries had planned a common effort and entered into a combination for the conduct of a business enterprise, the organization was distinguishable from the ordinary trust.

In the course of its opinion, the Court delineated the characteristics of a corporation, which if present, would be sufficient to qualify the organization as an association taxable as a corporation under the Federal Tax Law, as follows:

1. Associates—The members must be associates in that they must have entered into a joint enterprise for the purpose of transacting business.

2. Title—Title to the property acquired in the undertaking would be held by the organization as an entity and not by the beneficiaries as individuals.

3. Centralized management—The management is centralized in persons who have control of the property and who are charged with the conduct of the enterprise.

4. Continuity of Life—The organization continues without termination or interruption by the death of the owners of beneficial interests or by the transfer of beneficial interests.

5. Limited Liability—Personal liability of the participants is limited to the property involved in the undertaking.

6. Free Transferability of Interests—Beneficial interests may be transferred without affecting the continuity of life of the enterprise and the ownership of units of beneficial interest by a large number of individuals would not cause difficulty.

The Court found that all of the above listed characteristics of a corporation were present in the business trust under consideration in the *Morrissey* case. It further pointed out that certain features usually

found in corporations are not essential to a determination that an organization is an association taxable as a corporation. It is not necessary for the holders of the beneficial interests to have control over the operation of the business, as it is in the case of a corporation. Furthermore, the absence of particular corporate forms or of the usual terminology of corporations is not determinative. In the three companion cases the Court pointed out other features that would not be required, thus, operations may be limited to one project, as a single oil well lease,¹⁷ or apartment house;¹⁸ no meetings need be held or records kept;¹⁹ the organization need not have an office, by-laws or seal and the number of beneficiaries may be small.²⁰

A medical clinic was first before an appellate court in 1936 in the *Pelton* case.²¹ There several Illinois doctors entered into a trust indenture whereby they transferred certain equipment to themselves as trustees. The beneficial interests were represented by transferable shares, although options to purchase were given other beneficiaries before any such interest could be sold to outsiders. The trust was designated "The Pelton Clinic." The beneficiaries were given the power to fill vacancies among the trustees. Upon the death of a beneficiary, his beneficial interest passed to his wife or other relative, subject however, to the repurchase option by the trustees or other beneficiaries. The trust was to last ten years, at which time the assets would be distributed to the then beneficiaries.

The Court here found that all the corporate characteristics mentioned in the *Morrissey* and companion cases were present. It specifically noted that a corporation could not practice medicine in Illinois²² but dismissed this obstacle by quoting from the then current regulation:—" . . . organizations . . . are associations within the meaning of the statutes even though under State Law such organizations are technically partnerships."²³ This case was subsequently cited with approval by the Courts on the proposition that how an organization is classified under State law is not controlling for Federal Tax purposes.²⁴

The first tax case involving an association which was organized as an association rather than a trust was that of *Kintner v. United States*,²⁵ which was decided in 1954. A group of Montana doctors had

¹⁷ *Helvering v. Combs*, *supra* note 10.

¹⁸ *Swanson v. Commissioner*, *supra* note 10.

¹⁹ *Helvering v. Coleman-Gilbert Associates*, *supra* note 10.

²⁰ *Helvering v. Combs*, *supra* note 10.

²¹ *Pelton v. Commissioner*, 82 F. 2d 473 (7th Cir. 1936). 36-1 U.S. Tax Cas. ¶9195.

²² *People v. United States Medical Service*, 362 Ill. 442, 200 N.E. 157 (1936).

²³ *Pelton v. Commissioner*, *supra* note 21 at 476.

²⁴ *Wholesalers Adjustment Co. v. C.I.R.* 88 F. 2d 156, 37-1 U.S. Tax Cas. ¶9109. (8th Cir. 1937); *Commissioner v. Highlands Evanston Lincolnwood Subdivision*, 88 F. 2d 355, 37-1 U.S. Tax Cas. ¶9119 (7th Cir. 1937); *Burk-Wagoner Oil Assn. v. Commissioner*, 296 U.S. 110, 1 U.S. Tax Cas. ¶143, (1925); *Giant Auto Parts, Ltd. v. Commissioner*, 13 T.C. 307, 308 (1949).

²⁵ *Supra* note 14.

dissolved their partnership and transferred the assets to "The Western Montana Clinic" in order to operate as an association taxable as a corporation. The association was to continue until the death of the last survivor of the original members. The articles of association provided for both senior and junior members and that the business affairs were to be managed by an executive committee consisting of five individuals elected by the senior members. Membership was limited to physicians and surgeons licensed to practice medicine in the State of Montana. It was provided that only the members were to be liable to third parties for professional misconduct, and that any indebtedness incurred by the association through the act of a member, without the approval of the executive committee, was chargeable to the member concerned. Furthermore, the articles provided that the death or retirement of a member was not to result in dissolution of the association, and beneficial interests of members were non-assignable.

Immediately after organization, the Clinic had set up a pension plan whereby the doctor employees were given credit for their past service in the partnership in the formula computing the pension benefits. Contributions to this pension plan were deducted by the clinic when it filed its corporate income tax returns, and it also paid social security taxes and withholding taxes on each of its members. In addition, the clinic had set up a reserve fund to cover anticipated operating expenses for future years. Instead of receiving an interest in the assets of the Association, each member agreed that upon his death or withdrawal, he would accept the benefits of a pension plan, the cost of which was to be borne by the Association.²⁶

The Commissioner contended that Dr. Kintner and his wife (since Dr. Kintner filed a joint return) should report his share of the reserve fund and pension plan contribution by the clinic as part of his income. In deciding the case, the District Court²⁷ construed the *Morrissey* case and other Circuit Court decisions²⁸ as not requiring that all tests stated in the *Morrissey* decisions must be met in each instance. It found that the Western Montana Clinic more closely resembled a corporation than a partnership for the following reasons:

1. Title to property was held by the organization as an entity;
2. There was continuity of life;
3. There was centralized management;

²⁶ A provision such as this might cause the pension plan to fail to qualify because not entered into for the exclusive benefit of employees. A buy and sell agreement funded with life insurance would seem to be a much more preferable method of retiring a member's interest in the assets.

²⁷ 107 F. Supp. 976 (D.C. Mont. 1952).

²⁸ C.I.R. v. Brouillard, 70 F. 2d 154 (10th Cir. 1934); Bert v. Helvering, 92 F. 2d 491, 495, 37-2 U.S. Tax Cas. ¶9395 (CA-D.C. 1937) where the court stated, "... the real test is whether the enterprise more clearly resembles in general form and mode of procedure a corporation than a partnership."

4. The beneficial interests were transferable even though subject to restrictions.

It was conceded that the personal liability feature more closely resembled a partnership than a corporation.

On appeal the Government contended that the District Court decision should be overthrown on the ground that the practice of medicine in the State of Montana is personal and that a corporation could not practice medicine. The 9th Circuit Court of Appeals held, however, that based on the *Pelton* decision and the Commissioner's own regulations, the contention of the taxpayers should be upheld. The Court stated:

It should be added that it would introduce an anarchic element in Federal taxation if we determine the nature of associations by State criteria, rather than by said criteria sanctioned by Tax Law, the regulations and the Courts. It would destroy the uniformity so essential to a Federal Tax System—a uniformity which calls for equal treatment of taxpayers, no matter in which state their activities are carried on, if it would mean that tax incidents as to taxpayers in the same category would be determined differently according to the law of the state of residence.²⁹

The Court allowed the deduction of contributions for the pension plan and even permitted the past service of the doctors while partners to be counted in the pension formula. Many attorneys feel that the allowance of the past service credit probably would not be sustained by other Courts under the present status of the law. However, such service might be counted if the Keogh Bill ever becomes law.³⁰

Approximately two years after the *Kintner* decision, the Commissioner issued Revenue Ruling 56-23³¹ wherein he announced that he would not follow the *Kintner* decision in similar fact situations, either as to the determination that such an organization was an association or as to the allowance of past service for sole proprietors or partners, in the computation of benefits under a qualified pension plan. This ruling was issued at a time when the request for a ruling in respect to the Sheboygan Clinic was pending in the Commissioner's office, and was regarded as a refusal to recognize the tax status of the Sheboygan Clinic or the deduction of contributions under its pension plan.

Revenue Ruling 56-23 was relaxed by the Commissioner in Revenue

²⁹ *Supra* note 14 at 424. The court distinguished the *Mobile Bar Pilots Ass'n. v. Commissioner*, 97 F. 2d 695 (5th Cir. 1938), 38-2 U.S. Tax Cas. ¶9405 which had held that due to the personal nature of a pilot's service, an association of harbor pilots could not be classified as a corporation on the grounds that the pilots' association did no business except as an agent of its individual members, it owned no property, and had no income as an entity.

³⁰ H.R. 10, 86th Cong.

³¹ 1956-1 Cum. Bull. 598.

Ruling 57-546.³² In that Ruling the Commissioner said that he would not automatically treat an unincorporated association of doctors or other professionals as if it were a partnership, just because it sets up a pension plan that includes professional members. He announced that the usual tests would be applied in determining whether a particular organization of doctors or other professional groups had more of the characteristics of a corporation than a partnership. He promised a new ruling laying down the basic criteria for deciding whether an association is taxable as a corporation in the near future. This was followed by the proposed regulations published on December 23, 1959, which will be discussed later.

The most recent Court decision in respect to this problem is *Galt v. United States*.³³ There a group of Texas doctors dissolved their partnership and transferred the assets to the newly formed "Southwest Clinic Association." All of the personnel of the partnership became employees of the Association. Of the seven associates, the three senior members each had a 22.22% interest and the combined interests of the other four members was 33.33%. The associates elected a Board of Directors who in turn appointed an executive committee of two doctors from the Board to control the details of management. A business manager was hired who was under the control of the executive committee. An associate had no specific share of the assets, which were to be distributed only upon dissolution. Upon retiring at age sixty-five, an associate would receive one year's salary. Ownership of units of interest in the association was transferrable, but the other members had a first option to purchase such units. There was no individual liability for the indebtedness of the association until all of the association's assets had been used first. The association paid social security and withholding taxes and had filed the usual corporate income tax return.

The Court found that there were sufficient corporate characteristics so that the organization was an association taxable as a corporation. The Court held that although the association met all the requirements of a corporation under Texas law, the State law did permit doctors to form an association to do what they otherwise could do as a corporation. The Court concluded, without citation of any precedent, that ". . . the act of a State can neither raise nor lower the Federal taxes that may be due by the association by whatever name it may be called under the laws of a particular State."³⁴

THE PROPOSED REGULATIONS

Section 7701(a)(3) of the 1954 Code is identical to Section 3790

³² 1957-2 Cum. Bull. 886.

³³ *Supra* note 15.

³⁴ *Id.* at 362.

of the 1939 Code. Thus, until new regulations become final under the 1954 Code, the old regulations will remain in force. The old regulations, Reg. 118, Section 39.3797, are undoubtedly based upon the criteria set forth by the U.S. Supreme Court in the *Morrissey* case and subsequent decisions. Two points are of particular interest.

First, the regulations specifically state that for the purposes of qualification under the Internal Revenue Code, local law is of no importance.³⁵ This follows from the *Pelton* case and the subsequent decisions.

Second, the regulations specifically provide that any organization created for the transaction of designated affairs, which continues notwithstanding that its members or participants change, and whose affairs are conducted by a single individual, a committee, a board or some other group acting in a representative capacity, is included in the term 'association' as used in the Internal Revenue Code. The regulations specifically state:

It included a voluntary association, a joint stock association or company, a business trust, a Massachusetts trust, a common law trust, an inter-insurance exchange operating through an attorney in fact, a partnership, association and any other type of organization which is not within the meaning of the Code, a trust or an estate or a partnership.³⁶

The proposed regulations, Section 301.7701, go into more detail in several respects and give examples of organizations which do and which do not meet the requirements of an association taxable as a corporation. Two of these examples concern doctors forming an association. In one example the facts illustrate an association which would be taxable as a corporation, while the other example states that the organization illustrated would be classified as a partnership.

Section 301.7701-1(b) in referring to the categories into which organizations fall for purposes of taxation, states—

The tests or standards which are to be applied in determining the classification in which an organization belongs (whether it is an association, a partnership, a trust or other taxable entity) are determined under the Internal Revenue Code.

The standards and tests to be applied are set forth in Sections 301.7701-2 through 301.7701-4. Section 301.7701-1(c) states in part:

Although it is the Internal Revenue Code rather than local law which establishes the tests or standards which will be applied in determining the classification in which an organization be-

³⁵ Reg. 118, §39.3797-1. "For the purpose of taxation the Internal Revenue Code makes its own classification and prescribes its own standards of classification. Local law is of no importance in this connection."

³⁶ Reg. 118 §39.3797-2.

longs, local law will govern in determining whether the legal relationships which have been established in the formation of the organization are such that the standards are met. Thus, it is local law which must be applied in determining such matters, as the relationships of the members of the organization among themselves and with the public at large, and the interests of the members of the organization and its associates.

The above quotation appears to contradict the old regulations which simply state that "local law is of no importance," and this has caused concern among some of the commentators.³⁷ Yet this should not be regarded as a change in the present law. The terse statement that local law was of no importance referred to the standards of classifications set by the Internal Revenue Code, and not to the question of whether these standards had been met.³⁸ The relationships of the parties between themselves and with the public of necessity must be determined by local law or else there would be no tax uniformity. For example, assume that an organization in State A provides for continuity of life in its Articles, and an organization in State B does not. Assume further that under the local law of State A there can be no continuity of life regardless of what the Articles of Association state. If it is assumed that the element of continuity of life will determine the organization's Federal tax status, it is clear that neither organization has this element in actuality and therefore neither should be taxed as a corporation. Yet, if local law were of no importance in this respect, the organization in State A would be taxed as a corporation and one in State B would not. As previously noted,³⁹ the *Kintner* decision was attempting to seek tax uniformity. Only by interpreting the language in that case and in the proposed regulations to mean that local law is of no importance as to the standards, but is determinative as to whether these standards have been met, can this objective be obtained.

The proposed regulations Section 301.7701-2 sets out the characteristics of corporations under which an association will be classified to determine its status for tax purposes. These characteristics are as follows:

1. Associates.
2. An objective to carry on business and divide the gains therefrom.
3. Continuity of life.
4. Centralization of management.

³⁷ Hewitt, *Proposed Kintner Regulations Opposed at IRS Hearing*, 12 J. Taxation 217 (April 1960); Nolan, *A Tumult in the Industry*, XIV J. Am. Soc'y C.L.U. 217 (Summer 1960). 606 CCH 1960 Stand. Fed. Tax Rep. 8770A and 8973; Saltz, *Associations*, 38 Taxes 187 (March 1960).

³⁸ *Supra* note 35.

³⁹ See page 133 of this article.

5. Liability for corporate debts limited to corporate property.⁴⁰
6. Free transferability of interests.

ASSOCIATES AND OBJECTIVE TO CARRY ON BUSINESS

The regulations point out that associates and an objective to carry on business and divide the gains therefrom are essential to all business organizations other than sole proprietorships and the so-called one-man corporations. Without both of these characteristics, no organization would be classified as one taxable as a corporation.⁴¹

CONTINUITY OF LIFE

The characteristic of continuity of life is not present if the death, insanity, bankruptcy, retirement, resignation or expulsion of a member will cause dissolution of the organization.

In determining whether any member has the power of dissolution, the regulations state it will be necessary to examine the agreement and to ascertain the effect of such an agreement under local law. The difficulty to the commentators⁴² on this subject arises out of the provisions in the Uniform Partnership Act, which are embodied in Section 123.26 of the Wisconsin Statutes relating to causes of dissolution. The particular language in point reads as follows:

"Dissolution is caused . . . (4) By the death of any partner."

Taken alone, this provision would indicate that the death of a partner causes dissolution of the partnership, irrespective of a provision in the agreement to the contrary. Under this interpretation a partnership under local law could not achieve continuity of life, and would be seriously hampered in attempting to be classified as an association taxable as a corporation. Such interpretation appears erroneous both in Wisconsin and under the Uniform Partnership Act generally.

As early as 1854 the Wisconsin Supreme Court in *Shields v.*

⁴⁰ Enforcement of liability against unincorporated associations is provided for in Wisconsin by Chap. 226, §15, Laws of 1959 (Wis. Stats. §262.06 (7) 1959) which states, "A summons may be served individually upon any officer or director known to the plaintiff of an unincorporated association . . . where the claim sued upon arises out of or relates to association activities within the state sufficient to subject the defendant to personal jurisdiction A judgment rendered under such circumstances is a binding adjudication against the association as to its assets anywhere." See Smith, *Enforcing a Contractual Claim Against An Unincorporated Association in Wisconsin*, 1960 Wis. L. Rev. 444 (1960).

⁴¹ The Morrissey case appears to treat these two characteristics as one, but a separation may be made. Thus, "associates" signifies an individual closely connected or joined with others in a common purpose, activity or responsibility to partake or share in a common design, and implies participation by each of the individuals so united in the achievement of a common purpose. *Weir v. U.S.*, 92 F. 2d 634, 638 (7th Cir. 1937). If the "common purpose" were merely to manage and conserve property for the benefit of the associates, it would be an ordinary trust even though the beneficiaries of the trust are the persons who create it. Prop. Reg. 301.7701-4. If the "common purpose" is to carry on business and divide the gains, then the trust is a business trust.

⁴² *Supra* note 37.

*Fuller*⁴³ held that the death of one of the partners caused dissolution of the partnership. This rule was further developed in *Moore v. May*⁴⁴ where it was held that if the Articles of Partnership of a trade association provided that any member might withdraw in a manner prescribed, and if it was apparent that the intention of the firm was to consist of many members and continue for an indefinite period, the firm was not dissolved by the death of a member. Nor does it appear that the subsequent adoption of the Uniform Partnership Act changed this rule. In several jurisdictions subject to the Act where the question has arisen, the courts have held that death dissolves the partnership only if the articles of the organization do not provide to the contrary.⁴⁵ In light of *Moore v. May* and the statutory provision⁴⁶ that the Act shall be interpreted "to make uniform the law of those states which enact it," a similar decision could be expected in Wisconsin.

CENTRALIZATION OF MANAGEMENT

The next requirement is centralization of management. Citing as authority the *Morrissey* case, the regulations specifically provide that persons who hold management authority need not necessarily hold office as a result of selection by the members, and state that they may even be self-perpetuated in office. However, there would not be centralized management where the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

LIMITED LIABILITY

In respect to the characteristic of limited liability, personal liability is defined to cover the situation where a creditor of the organization may seek personal satisfaction from a member of the organization to the extent the assets of the corporation are insufficient to satisfy the claim. There is an interesting statement in the proposed regulation to the effect that personal liability does not exist when the members who are personally liable have risked no substantial assets. This novel test does not appear to be based upon existing law.

FREELY TRANSFERABLE INTERESTS

Although one of the listed characteristics is transferability of interests, organizations are not precluded from restricting transferability. Thus, the proposed regulations specifically permit a requirement that a member can only transfer his interest to a non-member after having offered such interest to other members at its fair market value. In the case of corporations greater restrictions are permitted. It would

⁴³ 4 Wis. 102 (1854).

⁴⁴ 117 Wis. 192, 94 N.W. 45 (1903).

⁴⁵ *Gerding v. Baier*, 123 Me. 264, 122 Atl. 675 (1923); *Storer v. Ripley*, 12 Misc. 2d 662, 178 N.Y.S. 2d 7 (1958); *Abel v. O'Hearn*, 97 Cal. App. 2d 747, 218 P. 2d 827 (1950); *McClennen v. C.I.R.*, 131 F. 2d 165 (1st Cir. 1942).

⁴⁶ Wis. Stats. §123.02(4).

seem that similar restrictions should be allowable in the case of associations taxable as corporations.

The characteristics listed in the regulations are followed by seven examples illustrating the applicability of the characteristics in specific situations. One gathers from the examples that it is not necessary that each organization fully meet the letter of each of the six listed characteristics, although the requirement as to associates and objective to carry on business for profit must be present in all cases. Thus, in the first example, the organization illustrated did not have the characteristic of limited liability, but it did have the characteristic of centralized management, continuity of life and a modified form of transferability of interests. That organization was qualified as an association for purposes of the Internal Revenue Code.

A rather extensive discussion of the problem was made in an Office Memorandum issued in April of 1960 by the Commissioner of Internal Revenue to the District Director at Milwaukee in respect to the Sheboygan Clinic. The Office Memorandum discusses first the facts, then the application of the existing law, but most interesting is the determination of the Commissioner which is found on pages 7 and 8 of this Memorandum. We are setting this determination out in full below.⁴⁷

Under the Articles of Association of Sheboygan Clinic, now in effect a number of individuals have joined together for a common purpose, i.e. for the furnishing of medical, surgical, dental and optometry services to the general public in the City of Sheboygan and surrounding area, and the sharing of any profits arising from such activities.

Since Article XXV of the Articles of Association specifically provides that neither the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member shall cause the dissolution of the association, it is held that such organization possesses the continuity of life characteristic of a corporation for all purposes of the Internal Revenue Code.

By Article VII of the Articles of Association, management of the Clinic is vested exclusively in an executive committee consisting of 5 members. Therefore, it is our position that the Clinic has centralized management in a representative capacity characteristic of corporate management which survives the death, disability, withdrawal or resignation of an officer, director or stockholder.

Accordingly, based upon the above facts and circumstances it is concluded that the Sheboygan Clinic should be treated under the agreement now in effect as an association taxable as a corporation for all purposes of the Internal Revenue Code. It is

⁴⁷ A copy of this Office Memorandum has been furnished the writers through the courtesy of Mr. Jacob F. Federer of Federer, Grote, Hesslink, Rohde & Neuses of Sheboygan, Wisconsin.

also now our view that the Clinic should have been treated as an association taxable as a corporation under the provisions of both the 1946 and 1948 agreements.

This technical advice memorandum will be of no force and effect with respect to taxable years of Sheboygan Clinic to which final regulations promulgated under Section 7701 of the Internal Revenue Code of 1954 must be applied.

In the last paragraph of the quoted portion, the Commissioner stated that it will have no force and effect in respect to taxable years to which final regulations promulgated under Section 7701 of the 1954 Code must be applied. While this seems to open the door to a contention that the Regulations under the 1939 Code and proposed regulations under the 1954 Code are different, it is difficult to see how this can be so. The statutory language is the same in both the 1939 and 1954 Codes. Courts in at least two instances have passed on medical clinics set up under that particular language. It does not seem that at this time the Commissioner can effect a change in the law by effecting a change in the regulation.

AFTER 1960, WHAT NEXT?

One could scarcely give an analysis of the present status of the law without at least mentioning in passing proposed changes. The most publicized proposed legislation in this field is HR-10, usually known as the Keogh Bill.⁴⁸ As originally introduced in the House of Representatives, this bill would permit self-employed individuals to set up retirement plans for themselves, subject to certain limitations and restrictions, which largely were concerned with the rate of contributions and early withdrawal. This Bill had been introduced in prior sessions of Congress in substantially similar form to that before the last session of Congress. In earlier sessions the Treasury Department always objected to passage of the Bill on the ground it would result in a loss of revenue. But in 1960 after the Bill had passed the House and was under consideration by the Senate Finance Committee, the Treasury made a rather curious about-face. It then said that it would withdraw its objection to passage of the Bill if it were amended so that any pension plan permitted under the provisions of the Bill would include other employees of the sole proprietor or partner, as well as the owners of the business on a non-discriminatory basis. In order to recoup some of the loss of revenue that it otherwise had expected, it requested that the requirements of present law on qualified pension plans be tightened up in respect to all small employers to prevent what it called abuses.⁴⁹

⁴⁸ *Supra* note 30.

⁴⁹ "Statement on Alternative Approach to H.R. 10 by David Lindsey, General Counsel of the Treasury, before the Senate Finance Committee, May 11, 1960, CCH Stand. Fed. Reps. No. 23, Part I, May 18, 1960.

This Bill as amended by the Finance Committee, was reported out to the Senate but was not acted upon before adjournment. There was much objection to the Bill in the form reported by the Senate Finance Committee, not only because of the restrictions upon new retirement plans for sole proprietors and partners, but because of the fact that such restrictions would adversely affect presently adopted pension and profit sharing plans, and would necessitate drastic and undesirable amendments to retain qualified status.

This brings us back to our starting point. At the outset it was stated that as a matter of principle, the tax treatment of the different forms of business organization should not be so different that the selection of one form of business organization as compared with another would depend upon the tax results obtained. While we are skeptical of achieving any Utopia on earth, we do believe that justice and equality under the law, even the tax law, is a goal to be sought. In almost every session of Congress, the Ways and Means Committee starts out by saying that it is going to undertake to close loopholes and achieve equality of treatment under the tax law. We recognize the magnitude of the task and the many difficulties involved, but we think the problem of deferred benefits for small businessmen is a field where the inequities of the tax law cry out for rectification.

The self employed or the member of a partnership should be afforded the same opportunities in respect to deferring compensation as any corporate executive.⁵⁰ Just as Section 401(a)(3)(B) prohibits pension plans which have the effect of discriminating in favor of employees who are officers, shareholders, supervisors, or highly compensated employees, neither should the law discriminate *against* these same individuals or against sole proprietors or partners who, due to the nature of their professional calling, cannot become corporate employees. The objectives of the Keogh Bill could be attained best through amendments to Sections 401 through 404 of the Internal Revenue Code, so that self-employed persons may be permitted to enjoy the benefits permitted corporate employees and executives under the present laws relating to qualified pension and profit sharing plans. Furthermore, the Treasury's requested restrictions as embodied in the Senate Finance Committee amendments to HR-10 are both unnecessary and unduly restrictive.

⁵⁰ We have not overlooked §1361 of the Internal Revenue Code of 1954 which permits certain partnerships and sole proprietorships to elect to be taxed as a domestic corporation. The requirement that capital be a material income producing factor eliminates most professional organizations. Furthermore, the limitation in §1361(d) that a partner or proprietor shall not be considered an employee for purposes of §401(a) precludes the objective of becoming eligible for pension trusts, etc. Beyond this, the election opens up a Pandora's Box of other problems, with which no professional organization deserves to be confronted.

CONCLUSION

Even though the Keogh Bill or similar legislation is enacted in a future session of Congress, permitting partners or sole proprietors to set up qualified pension plans under which they are included, continuity of life, centralized management, and transferability of ownership interests will continue to make the Common Law Trust and Association desirable forms of organization for professional people. It is hoped that the above analysis has demonstrated that such organizations can be safely set up under the Law.

APPENDIX

ARTICLES OF ASSOCIATION
(for unincorporated associations)*

We, the undersigned, individually,				
Name	Number	Street	City	State
.....
.....
.....
.....
.....
.....

being licensed to practice medicine in the State of Wisconsin, for the purpose of forming an association, do hereby adopt the following Articles of Association:

ARTICLE I
NAME

The name of the association is: MILWAUKEE CLINIC.

ARTICLE II
DURATION

The association shall commence on May 9, 1958, and continue until terminated by unanimous agreement of the associates.

ARTICLE III
PURPOSE

The purpose for which the association is organized is the practice of medicine and surgery, medical research, and related activities; provided that only licensed physicians shall control professional functions; and provided further that the personal and intimate relationship between physician and patient shall at all time be maintained inviolate.

ARTICLE IV
OFFICES

The offices of the association shall be located in Milwaukee, Wisconsin.

ARTICLE V
ASSOCIATES

SECTION 1. QUALIFICATIONS. The members of the association shall be known as associates. The present associates shall consist of the undersigned. Each associate shall continue as such until his membership in the association is terminated as herein provided. Associates may elect additional associates to membership and may on the death, resignation, removal or retirement of an associate elect a successor. The affirmative vote of two-thirds of the associates shall be required for such purposes. No person shall become an associate unless he is

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licensed to practice medicine in the State of Wisconsin and has agreed in writing to be bound by these articles of association.

SECTION 2. DEATH OR RETIREMENT. The death, resignation, removal or retirement of an associate shall not dissolve the association, and neither a retiring associate nor the estate or legal representatives of a deceased associate shall have any right, title or interest in the good will or any other property owned by the association. He shall be entitled solely to the earned and unpaid salary which may have accrued to the date of death, resignation, removal or retirement. Any death benefit, disability allowance or retirement income in which an associate may share shall be provided through a special fund and plan directly specified for such purposes and so limited.

SECTION 3. AUTOMATIC RETIREMENT. Each associate shall automatically retire upon attaining sixty-five years of age unless his term shall be extended with his approval and by vote of a majority of the associates.

SECTION 4. ANNUAL MEETING. The annual meeting of the associates shall be held on the first Monday in December in each year, beginning with the year 1958, at the hour of 7:00 p.m., for the purpose of electing governors and for the transaction of such other business as may come before the meeting.

SECTION 5. SPECIAL MEETINGS. Special meetings of the associates may be called by the board of governors or by not less than three associates, providing written notice of the meeting is mailed or delivered at least five days before the meeting to all associates. The attendance of an associate at any special meeting shall constitute a waiver of notice of such meeting.

SECTION 6. PLACE OF MEETING. All meetings shall be held at the offices of the association unless all the associates may in writing designate another place for a particular meeting.

SECTION 7. QUORUM. A majority of the associates shall constitute a quorum at any meeting of associates; provided that if less than a majority of the associates are present at said meeting, a majority of those present may adjourn the meeting from time to time without further notice.

ARTICLE VI

GOVERNORS

SECTION 1. GENERAL POWERS. The business and affairs of the association shall be managed by its board of governors.

SECTION 2. NUMBER, TENURE AND QUALIFICATIONS. The board of governors shall be composed of not less than three nor more than five of the associates. Each governor shall hold office until the next annual meeting of associates or until his successor shall have been elected and qualified. The first board of governors shall consist of

SECTION 3. REGULAR MEETINGS. A regular meeting of the board of governors shall be held immediately after and at the same place as the annual meeting of associates.

SECTION 4. SPECIAL MEETINGS. Special meetings of the board of governors may be called at the request of any two governors, providing written notice of the meeting is mailed or delivered at least five days before the meeting to all of the governors. The attendance of a governor at any special meeting shall constitute a waiver of notice of such meeting.

SECTION 5. QUORUM. A majority of the board of governors shall constitute a quorum for transaction of business at any meeting of the board of governors, provided, that if less than a majority of the governors are present at said meeting, a majority of the governors present may adjourn the meeting from time to time without further notice. The act of the majority of governors present at a meeting at which a quorum is present shall be the act of the board of governors.

ARTICLE VII

OFFICERS

SECTION 1. NUMBER. The officers of the association shall be a chairman, a vice-chairman, a secretary-treasurer and such other officers as may be elected by the board of governors from themselves.

SECTION 2. TENURE. The officers of the association shall be elected annually by the board of governors at the first meeting of the board of governors held

after each annual meeting of associates. Each officer shall hold office until his successor shall have been duly elected and qualified or until his death or until he shall resign or shall have been removed in the manner hereinafter provided.

SECTION 3. REMOVAL. Any officer elected by the board of governors may be removed by the board of governors whenever in its judgment the best interests of the association require such action, but such removal shall be without prejudice to the contract rights, if any, of the person removed.

SECTION 4. CHAIRMAN. The Chairman shall preside at all meetings of the associates and board of governors and shall in general supervise the business and affairs of the association. He shall sign all contracts authorized by the board of governors and shall perform such other duties as may be prescribed by the board of governors.

SECTION 5. VICE-CHAIRMAN. The vice-chairman shall perform the duties of the chairman in the event of his absence, disability or refusal to act.

SECTION 6. SECRETARY-TREASURER. The secretary-treasurer shall keep the minutes of the meetings of the associates and the board of governors. He shall sign and attest all contracts and shall give notices of meetings, when notice shall be required. He shall have custody of and be responsible for all funds of the association. He shall open bank accounts and shall deposit or cause to be deposited therein all moneys received by the association. He shall sign all checks and shall cause an annual audit of the affairs of the association to be made by a certified public accountant. He shall perform such other duties as may be assigned to him by the chairman or the board of governors.

ARTICLE VIII

MISCELLANEOUS

SECTION 1. CONTRACTS. Subject to the provisions of Section 2 of this article, the board of governors may authorize any officer or agent to enter into any contract or execute any instrument in the name of the association, and such authority may be general or confined to specific instances.

SECTION 2. SALARIES. The board of governors shall determine the salaries and bonuses paid to physicians and associates employed by the association and shall approve the terms of all contracts with physicians and associates before such contracts shall be executed.

SECTION 3. RETIREMENT PLAN. The board of governors shall have the power to arrange and provide for retirement and other benefits for associates and other persons employed by the association, including, without limiting the generality of the foregoing, the power to specify the age of retirement, to adopt a retirement plan and provide for the administration thereof and to provide for funding thereof.

ARTICLE IX

AMENDMENTS

These articles may be altered, amended or repealed and new articles may be adopted at any meeting of the board of governors by a majority vote of all of the board of governors. Such action shall be communicated in writing to the associated within fifteen days thereafter.

Dated: December 1, 1960.

being all of the associates of the association.